CONSTRUCTION | 18 DECEMBER 2010

SAUDI STEEL PIPES

CHANGE IN PRICE TARGET

Valuation looks attractive

We reduce our price target to SR27.0/share off the back of lower than expected performance but maintain our rating at Overweight on valuation grounds. We think the market is currently pricing an unrealistically pessimistic scenario creating an opportunity for long term value.

- **Sluggish demand could persist longer than expected**
  Our key argument for the stock has been that some of Aramco's projects that were delayed, due to the crisis, will come back on track from 4Q10. However, we now think the timing has become more uncertain. We revise our utilization assumptions to reflect the rising risk of slower than expected growth.

- **Rising pressure on margins lead to lower earnings**
  Given the weak demand environment, we think SSP will have to absorb some of the rise in costs of raw materials by selling at a lower markup. We think this will have a significant impact on future earnings growth. We revise markup estimates to reflect the weak demand environment

- **Our numbers imply conservative growth scenarios…**
  Despite the 12% rise last week, the stock is down 34.3% this year. Some decline from earlier levels this year is justified given the recent deterioration of performance, but we think the magnitude of the decline is unjustified. Our revised figures imply an average RoE of 11.5% over 2010-14e and 20.6% over the long term (versus an adj. RoE of 26% over 2006-09). Hence, we believe that our numbers imply a conservative scenario of sluggish growth over the next 5 years and mid-cycle levels over the long term.

- **… While current market price implies a "recession forever" scenario**
  In our view, the current market price implies an unrealistic scenario of "recession to perpetuity" which we regard as an overly pessimistic scenario and an opportunity for investors to capture long term value.

- **Valuation**
  We revise our valuation of SSP to SR27/share off the back of weaker than expected performance. However, we believe the stock decline has been overdone; hence we remain Overweight on valuation grounds.

Summary financials (Using proportionate consolidation method)

In SRmn, unless otherwise stated	2009	2010E	2011E	2012E	2013E	2014E
Revenues	539	581	600	771	950	1,154
EBITDA	131	91	99	138	182	229
Reported net income	113	71	63	85	124	173
Total debt	-	32	39	48	41	42
Div per share (SR)	2.0	1.5	1.0	1.3	2.0	2.5
EBITDA margin %	24.4	15.7	16.4	17.0	18.2	18.2
Net margin %	19.5	10.7	9.8	12.0	15.3	19.0
ROE %	17.2	7.9	7.5	10.0	14.2	19.4
EPS (SR)	2.6	1.4	1.2	1.7	2.4	3.4
Adjusted Cash EPS (SR)	2.9	1.6	1.8	2.4	3.2	4.0

Source: Company, NCBC Research estimates

OVERWEIGHT

Target price	27.0
Current price (SR)	22.4

STOCK DETAILS

M52-week range H/L (SR)	36.5/18.8
Market cap ($mn)	277
Shares outstanding (mn)	51
Listed on exchanges	TADAWUL

Price perform (%)	1M	3M	12M
Absolute	13.7	(10.4)	(30.0)
Rel. to market	12.8	(12.7)	(36.4)

Avg daily turnover (mn)	SR	US$
3M	8.5	2.3
12M	10.7	2.9

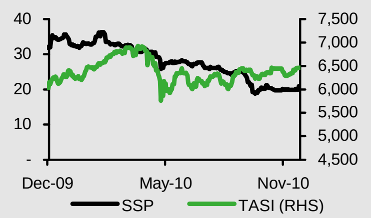
Reuters code	1320.SE
Bloomberg code	SSP.AB
	www.sspipe.com

VALUATION MULTIPLES

	09A	10E	11E
Reported P/E (x)	8.5	16.0	18.2
Adjusted P/E (x)	11.0	22.2	23.3
P/B (x)	1.2	1.5	1.5
EV/EBITDA (x)	6.1	8.7	8.1
Div Yield (%)	8.9	6.7	4.5

Source: NCBC Research estimates

SHARE PRICE PERFORMANCE



Source: Bloomberg

Ahmed Al Qahtani +966 2 690 7784
ah.alqahtani@ncbc.com

Investment View

Slower recovery leads to lower price target…

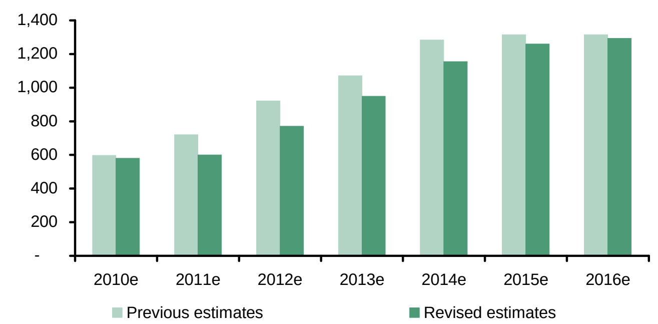
SSP was able to maintain high utilization rates and good margins over 2006-08 before a sharp decline in 2009 as a result of the global crisis. We saw a good recovery in H1 2010 which was driven by rising sales volume of both small and medium diameter pipes. However, we saw sharp reversal in 3Q10 that suggests that a slower recovery is more likely than we originally envisaged.

We expect some projects to come back on track leading to growth in demand, but the timing of these projects has become more uncertain. We originally expected some of these projects to come back in 4Q10 and early 2011, but this has not happened yet. This, in addition to revenue concentration, creates more uncertainty going forward leading us to adjust our sales volume and mark up on costs downwards resulting in lower estimates and valuation.

As a result of our new slower growth scenario, we adjust our estimates of sales volume and mark up estimates leading to downward revenue and margin revisions. The impact of margin adjustment has a more significant impact on net income estimate than revenue revision. Although we sharply revise our estimates over 2011-14e our longer term estimates are less impacted.

Exhibit 1: Revenue estimates

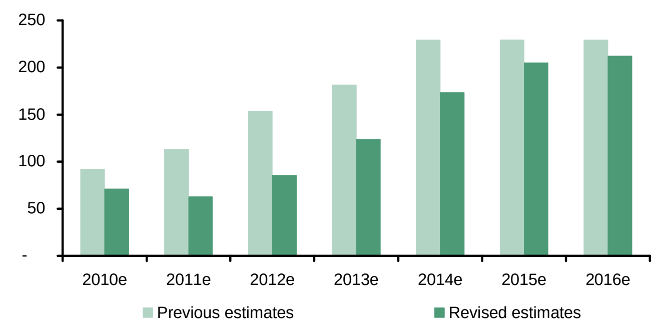
SRmn



Source: NCBC Research estimates

Exhibit 2: Net income estimates

SRmn



Source: NCBC Research estimates

…but the stock looks attractive on valuation grounds

SSP stock price has declined 34.3% YTD as the market adjusts to take into account the rising uncertainty of demand recovery. Hence, a decline from earlier levels, in our view, is justified, but the magnitude of that decline took the stock to unjustifiably low levels.

Our revised figures imply an average RoE of 11.5% over 2010-14e and 20.6% over the long term (versus an adj. RoE of 26% over 2006-09). Hence, we believe that our numbers imply a conservative scenario of sluggish growth over the next 5 years and mid-cycle levels over the long term.

In our view, the current market price implies an unrealistic scenario of “recession to perpetuity” which we regard as an overly pessimistic scenario and an opportunity for investors to capture long term value.

Earnings review

3Q10 earnings of SSP came in significantly below our estimates for the quarter as a result of a decline in revenues that was driven by a mix of factors that affected sales volume and selling price. Although we were expecting a decline in earnings, the magnitude of the decline exceeded our expectation.

Revenue pressure in 3Q10

What happened?

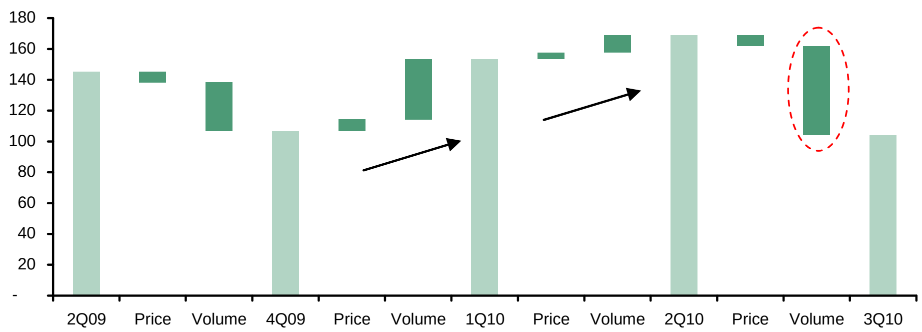
Higher demand driven by the rapid expansion in capex by regional governments and national oil companies led to an overall increase in revenues between 2006-08. This was combined with rising commodity prices which the company was able to pass to its customers (Steel is the main input for SSP).

However, the combination of the global crisis and drop in oil prices led to delays in many planned projects. Consequently, demand levels plummeted which negatively impacted the sales of medium diameter pipes (mainly sold to oil companies). Demand for small diameter pipes, however, did better as a result of the continued fiscal expansion by the Saudi government, until 3Q10.

In 3Q10, sales volume of both small and medium diameter pipes dropped 18.2% YoY and 34.3% QoQ leading to a significant pressure on revenues. The medium diameter segment is a volatile and cyclical business, so we were expecting the small diameter business to support revenues To our surprise, revenue from small diameter pipes dropped in 3Q10 41.7% QoQ and 26.7% YoY; underperforming the medium diameter segment.

Exhibit 3: Reversal of the recovery trend

SRmn



Source: Company, NCBC Research estimates

Why it happened?

In our initiation report, we highlighted that we expect earnings to decline in 2010 as a result of margin normalization (2009 margins were abnormally high) without a proportionate increase in revenues to offset the margins impact.

In 2010 so far, revenues have risen from the lows of 4Q09 before the unexpected decline in 3Q10. The decline was due to lower revenues of both the medium and the small diameter segments, but the magnitude of decline in each segment is different.

The utilization rate of the small diameter plant remained around 100% in 1Q10 and 2Q10 as demand driven by government spending mitigated the impact of the global crisis. In 3Q10, however, utilization dropped to 57.8% resulting in a significant decline in revenues, despite an improving pricing environment YoY.

For the medium diameter segment, utilization averaged around 84% over 2006-08 before declining to 56% in 2009 as a result of capex delays by Saudi Aramco and other regional oil and gas companies. In 2010, the capacity of this segment doubled to 160,000 tons per annum without any important changes in production volumes, this led to a drop in utilization rates.

Exhibit 4: Detailed revenue analysis of the different segments

	3Q-09	4Q-09	1Q-10	2Q-10	3Q-10	2008	2009
Small diameter							
Production capacity (tons)	20,000	20,000	20,000	20,000	20,000	80,000	80,000
Sales volume (tons)	17,354	16,342	20,885	19,845	11,559	79,303	60,274
Utilization %	86.8	81.7	104.4	99.2	57.8	99.1	75.3
Avg selling price (SR/ tons)	3,800	4,174	4,088	4,174	4,179	4,543	4,721
Revenue (SR'000)	**65,945**	**68,207**	**85,367**	**82,828**	**48,310**	**360,265**	**284,532**
Medium diameter							
Production capacity (tons)	20,000	20,000	40,000	40,000	40,000	80,000	80,000
Sales volume (tons)	12,578	9,061	13,846	17,428	12,932	80,097	56,858
Utilization %	62.9	45.3	34.6	43.6	32.3	100.1	71.1
Avg selling price (SR/ tons)	4,874	3,660	4,395	4,583	3,981	4,978	4,721
Revenue (SR'000)	**61,308**	**33,163**	**60,853**	**79,864**	**51,482**	**398,742**	**268,406**
Other revenues (SR'000)	3,572	5,400	5,905	6,115	4,315	57,867	22,734
Total revenue (SR’000)	**130,825**	**106,771**	**152,126**	**168,807**	**104,107**	**816,874**	**538,645**

Source: Company, NCBC Research estimates

The utilization rate of the medium diameter plant is largely dependant on Aramco’s planned projects. Earlier this year, we were expecting some projects to commence in 4Q10 which would lead to a rise in demand and revenue. However, this has not happened yet. We expect this picture to change once the economy recovers fully from the global crisis and oil prices return to sustainably high levels.

We believe that the projects should resume because oil has exceeded the $75 benchmark which the Saudi oil minister regarded as a required level for further investment. However, the timing of these projects remains uncertain and hence we reduce our future estimates of utilization rates in order to take that risk into account.

Margins are pressured by the slow demand

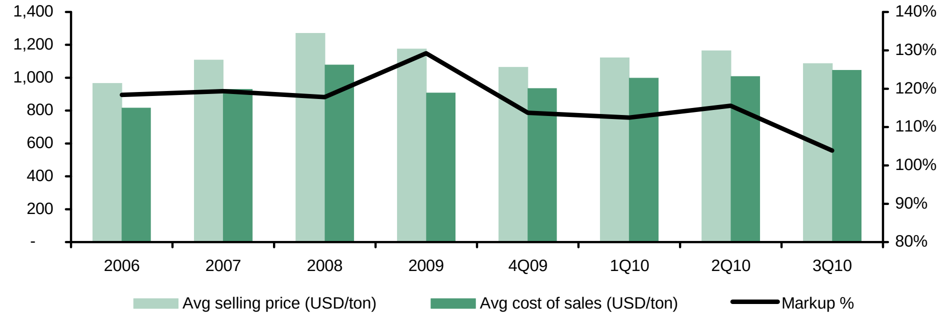
The company’s largest cost components are steel and zinc and comprise around 85% of the company’s cost of production. In normal markets, the company passes any increases in the cost of raw materials to their customers so that the selling price is determined on a cost plus basis. This has supported steady margins over the past few years.

However, due to the slow demand for the company’s products, especially in the medium diameter business, the company has had to reduce its markup and absorb some of the recent increase in raw material prices resulting in lower margins.

This was also magnified in 3Q10 by a “wait and see” approach by SSP’s customers who anticipated a softness in steel prices after the temporary decline in May through July this year. Although the decline did not continue, 3Q10 had already been impacted by customer’s expectations.

Exhibit 5: Narrowing gap between selling price and costs pressures margins

USD/ton (LHS), % (RHS)



Source: Company, NCBC Research

Going forward, we think that markup on small diameter pipes will remain stable over the next 2 years before we see a downward pressure over the longer term. This decline will be driven by a slow down in demand as mega government projects are completed.

However, we expect the opposite with the medium diameter pipes. We revise our estimates downwards for the next 2 years, taking into account a slow demand recovery before we return to normal mid-cycle levels in 2013 onwards.

Earnings outlook

From the previous discussion, we revise our future estimates for both the small and medium diameter segments.

Small diameter segment

Despite the drop in utilization rates in 3Q10 we think utilization rates could recover in 4Q10 and 2011e. Over the long term, we expect utilization rates for this segment to decline as mega projects are completed. Hence, we maintain 80% utilization in 4Q10e and 2011e before a gradual decline in 2012e onwards towards a sustainable utilization rate at 70%. We also expect markup on costs to remain somewhat stable in 4Q10e and 2011e before a gradual decline over the long term as demand slows down.

Medium diameter segment

We estimate this segment to continue to run at very low utilization rates in 4Q10e and 2011e before we see a gradual rise as some of Aramco's projects come back on stream. However, given the high uncertainty of the timing of these projects and the risk of business concentration, we assume utilization to rise slowly toward 50% in 2013e and we assume a sustainable utilization rate at 70%. We also revise our markup estimates downwards given the risk of rising excess supply over 4Q10-2011e before returning to normalized levels in 2013e onwards.

Large diameter segment

In line with our conservative revisions, we also revise ours assumptions for the large diameter pipes in order to maintain a consistently conservative approach in valuing the company. We adjust both, utilization rates and markups downwards resulting in a lower net income over 2012-2016e.

It is important to keep in mind that this segment is not consolidated; hence this revision will not have an impact on revenues or costs, however, it will affect net income through its impact on income from associates.

Exhibit 6: We revise our estimates downwards off the back of weaker than expected results

In SRmn, unless otherwise stated

		2010E	2011E	2012E	2013E	2014E	2015E	2016E
Revenue	Current	581	600	771	950	1,154	1,260	1,293
	Previous	597	720	922	1,071	1,283	1,314	1,315
	Chg %	(2.8)	(16.7)	(16.4)	(11.3)	(10.1)	(4.1)	(1.6)
Gross profit	Current	101	94	121	162	216	249	257
	Previous	120	144	189	220	271	272	272
	Chg %	(15.9)	(34.7)	(36.1)	(26.1)	(20.3)	(8.3)	(5.3)
Net income	Current	71	63	85	124	173	205	212
	Previous	92	113	153	181	229	229	229
	Chg %	(22.6)	(44.5)	(44.5)	(31.9)	(24.3)	(10.6)	(7.4)
Price Target (SR/share)	Current	27						
	Previous	37						
	Chg %	(27.8)						

Source: NCBC Research estimates

Financials

Exhibit 7: Income statement (Using proportionate consolidation method)

In SR mn, unless otherwise stated

	2009	2010E	2011E	2012E	2013E	2014E
Net sales	539	581	600	771	950	1,154
% change	(34.1)	7.8	3.4	28.4	23.2	21.5
COGS	(399)	(479)	(506)	(650)	(787)	(938)
Gross profit	**140**	**101**	**94**	**121**	**162**	**216**
Operating expenses	(26)	(29)	(30)	(33)	(35)	(39)
Operating profit	**114**	**72**	**65**	**88**	**127**	**177**
EBITDA	**131**	**91**	**99**	**138**	**182**	**229**
% change	(15.5)	(30.4)	7.9	39.6	32.4	25.8
Dep. & Amortization	(18)	(19)	(34)	(49)	(55)	(52)
Financing cost, net	(3)	(1)	(2)	(3)	(4)	(4)
Other income (expense)	2	-	-	-	-	-
Non-recurring expenses						
Reported net income ^	**113**	**71**	**63**	**85**	**124**	**173**
Tax (Zakat)	(8)	(9)	(4)	(5)	(8)	(12)
Adjusted net income	**105**	**62**	**59**	**80**	**115**	**162**

Source: Company, NCBC Research estimates

^ SSP reports net income before deducting Zakat and Taxes due to a Saudi accounting rule that dictates on companies with mixed ownership (Saudi and foreign) to deduct Zakat and taxes directly from equity without appearing on the income statement.

Exhibit 8: Balance sheet

In SR mn, unless otherwise stated

	2009	2010E	2011E	2012E	2013E	2014E
Cash & short term investments	369	221	124	58	66	82
Accounts receivable	95	100	104	115	130	147
Inventory	239	202	218	236	259	283
Prepayments	8	6	7	8	8	10
Current assets	**712**	**529**	**453**	**416**	**463**	**523**
Investment in associates	45	45	45	58	76	101
Net fixed assets	224	403	479	548	542	537
Deferred expenses	0	0	0	0	0	0
Total assets	**981**	**977**	**977**	**1,023**	**1,081**	**1,160**
Accounts payables & accruals	60	61	68	74	85	100
End of service indemnity	26	29	32	35	38	41
Dividends payable	102	77	51	64	102	128
Current liabilities	**188**	**167**	**151**	**173**	**225**	**268**
Total debt	0	32	39	48	41	42
Total liabilities	**188**	**199**	**190**	**221**	**266**	**311**
Share capital	510	510	510	510	510	510
Additional paid-in capital	219	219	219	219	219	219
Employees' stock program	(16)	(16)	(16)	(16)	(16)	(16)
Reserves	25	32	38	45	57	73
Retained earnings	55	34	36	44	46	64
Shareholder's equity	**793**	**778**	**786**	**802**	**816**	**850**
Total equity & liab	**981**	**977**	**977**	**1,023**	**1,081**	**1,160**

Source: Company, NCBC Research estimates

Exhibit 9: Cash flow statement

In SR mn, unless otherwise stated

	2009	2010E	2011E	2012E	2013E	2014E
EBIT	115	72	65	87	125	174
Depreciation & amortization	18	19	34	40	46	43
Income from associates	-	-	-	(15)	(34)	(62)
Other non-cash items	-	-	-	-	-	-
Zakat and tax payment	(8)	(9)	(4)	(5)	(7)	(10)
Change in working capital	12	35	(14)	(23)	(28)	(28)
Other assets/liab	2	3	3	3	3	3
Operating cash flows	**140**	**121**	**84**	**87**	**104**	**120**
Capital expenditure	(48)	(197)	(110)	(110)	(40)	(38)
Investment in associates	(45)	-	-	-	-	-
Dividends received	-	-	-	1	17	37
Proceeds from sale of fixed assets	-	-	-	-	-	-
Investing cash flows	**(93)**	**(197)**	**(110)**	**(109)**	**(23)**	**(1)**
IPO proceeds	363	-	-	-	-	-
dividends paid	(70)	(102)	(77)	(51)	(64)	(102)
Debt issuance/repayment	(50)	32	7	9	(7)	2
Financing cost	(3)	(1)	(2)	(2)	(2)	(3)
Financing cash flows	**240**	**(71)**	**(71)**	**(44)**	**(74)**	**(103)**
Net cash flows for the year	**286**	**(148)**	**(97)**	**(66)**	**8**	**16**
Beginning cash balance	82	369	221	124	58	65
Ending cash balance	**369**	**221**	**124**	**58**	**66**	**82**

Source: Company, NCBC Research estimates

Exhibit 10: Key ratios

In SR mn, unless otherwise stated

	2009	2010E	2011E	2012E	2013E	2014E
Per share ratio (SR)						
Reported EPS	2.6	1.4	1.2	1.7	2.4	3.4
Adjusted EPS	2.4	1.2	1.2	1.6	2.3	3.2
Adjusted cash EPS	2.9	1.6	1.8	2.4	3.2	4.0
FCF per share	1.1	(1.5)	(0.5)	(0.4)	1.6	2.3
Div per share	2.0	1.5	1.0	1.3	2.0	2.5
Book value per share	18.4	15.3	15.4	15.7	16.0	16.7
Valuation ratio (x)						
P/E	8.5	16.0	18.2	13.5	9.3	6.6
Implied P/E	11.0	22.2	23.3	17.3	11.9	8.5
P/FCF	20.8	(14.9)	(44.1)	(52.3)	14.1	9.6
P/BV	1.2	1.5	1.5	1.4	1.4	1.3
EV/sales	1.5	1.4	1.3	1.2	1.1	0.9
EV/EBITDA	6.1	8.7	8.1	7.1	5.8	5.1
Div yield (%)	8.9	6.7	4.5	5.6	8.9	11.2
Profitability ratio %						
Gross margins	25.9	17.5	15.7	15.5	16.3	17.1
Operating margin	21.1	12.5	10.8	10.9	12.0	13.1
EBITDA margins	24.4	15.7	16.4	17.0	18.2	18.2
Net profit margins	19.5	10.7	9.8	12.0	15.3	19.0
ROE	17.2	7.9	7.5	10.0	14.2	19.4
ROA	12.8	6.3	6.0	8.0	11.0	14.4
Liquidity ratios (x)						
Current ratio	3.8	3.2	3.0	2.4	2.1	1.9
Quick Ratio	2.5	2.0	1.6	1.0	0.9	0.9
Operating ratios (days)						
Inventory days	216	152	155	152	148	144
Receivables days	63	62	62	62	62	62
Payables days	54	46	48	48	49	51
Operating cycle	279	214	217	214	210	207
Cash cycle	225	168	169	166	162	156
Production capacity ('000 tons)						
Capacity of small diameter plant	80	80	80	80	80	80
Utilization (%)	75.3	80.0	80.0	78.0	76.0	74.0
Capacity of small diameter plant	80.0	160.0	160.0	160.0	160.0	160.0
Utilization (%)	71.1	41.1	40.1	45.1	51.1	58.1
Capacity of large diameter plant	-	-	-	200	200	200
Utilization (%)	-	-	-	30.0	50.0	70.0

Source: Company, NCBC Research estimates

Kindly send all mailing list requests to research@ncbc.com

Head of Research

Eiji Aono
e.aono@ncbc.com
+966 2690 7786

Brokerage website

www.alahlitadawul.com
www.alahlibrokerage.com

Corporate website

www.ncbc.com

NCBC Investment Ratings

OVERWEIGHT: Target price represents expected returns in excess of 15% in the next 12 months

NEUTRAL: Target price represents expected returns between -10% and +15% in the next 12 months

UNDERWEIGHT: Target price represents a fall in share price exceeding 10% in the next 12 months

PRICE TARGET: Analysts set share price targets for individual companies based on a 12 month horizon. These share price targets are subject to a range of company specific and market risks. Target prices are based on a methodology chosen by the analyst as the best predictor of the share price over the 12 month horizon

Other Definitions

NR: Not Rated. The investment rating has been suspended temporarily. Such suspension is in compliance with applicable regulations and/or in circumstances when NCB Capital is acting in an advisory capacity in a merger or strategic transaction involving the company and in certain other situations

CS: Coverage Suspended. NCBC has suspended coverage of this company

NC: Not covered. NCBC does not cover this company